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SUPREME COURT OF THE UNITED STATES

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Sup Ct.

OCTOBER TERM, 1946

No. 347

PHILLIPS PETROLEUM COMPANY,
Petitioner,

vs.

CLAY JOHNSON,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

DON EMERY,
RAYBURN L. FOSTER,
E. H. FOSTER,
CHARLES B. COCHRAN,
WARREN M. SPARKS,
Counsel for Petitioner.

INDEX

Subject Index

	Page
Petition for writ of certiorari	1
I. Opinions of the Circuit Court of Appeals	2
II. Jurisdiction	2
III. Summary Statement of Matters Involved	2
Holdings of the Majority of the Court	5
The Dissenting Opinion	8
IV. Questions Presented	8
Question 1	8
Question 2	9
Question 3	9
Question 4	9
V. The Writ should be granted although the case was reversed and remanded by the Court of Appeals	10
VI. Reasons relied on for allowance of the Writ	10

1. The holding of the Court of Appeals that, under a royalty provision which reads "the lessor shall be paid at the rate of 1/8 of the net proceeds derived from the sale of gas at the mouth of the well," where the gas was not sold at the well but commingled with other gas produced from hundreds of other wells so its identity was lost in the mixture, and the mixture processed in eight gasoline plants and a part of the products manufactured used in making other products and part of them sold so that it was impossible to trace the Johnson gas into the proceeds of any of the products manufactured from the mixture of gases, that royalties should not be determined by the market value of the gas at the well but by "1/8 of the fair value of the gasoline separated out and used and 1/8 of the proceeds of sale of the residue gas, less a proper credit for the cost of transporta-

Page

tion, separation, and sale'' is a decision of an important question of law probably in conflict with the decisions of other Circuit Courts of Appeals and with prior decisions of the same Court of Appeals 11

2. The holding of the Court of Appeals that the commingling of the Johnson gas with gas produced from hundreds of other wells and the processing of the mixture for its gasoline content in eight gasoline plants was not a ''use'' of the gas is a decision of an important question of law probably in conflict with the decisions of other Circuit Courts of Appeals and with prior decisions of the same Court of Appeals 16

3. The holding of the Court of Appeals that ''the measure of accountability is one-eighth of the fair value of the gasoline separated out and used, and one-eighth of the proceeds of sale of the residue gas, less a proper credit for the cost of transportation, separation and sale'' where it was admitted that the proceeds of the Johnson gas could not be traced into the products manufactured from the mixture is in effect a holding that royalties should be determined by the actual value of the gas without prior proof of no market value, which holding is a decision of an important question of local law probably in conflict with applicable local decisions 20

4. The holding of the Court of Appeals that under a royalty provision for a payment of ''⅛ of the net proceeds derived from the sale of gas at the mouth of the well'' the proceeds contemplated by the parties were not those from a sale of the gas in its natural state as produced at the well but from products manufactured from

Page

the gas is a decision of an important question of local law probably in conflict with applicable local decisions, with decisions of other Circuit Courts of Appeals and with prior decisions of the same Court 21

VII. Conclusion 24

TABLE OF CASES CITED

Armstrong v. *Skelly Oil Company*, 55 F. (2) 1066 .... 11, 14
Continental Oil & Cotton Company v. *Wristen & Johnson*, 168 S. W. (2) 395 (Tex. C. C. A.) 12, 20
Danciger Oil and Refineries, Inc., v. *Hamill Drilling Company*, 171 S. W. (2) 321 (S. Ct. of Tex.) 21, 22
Dunn v. *Republic Natural Gas Co.*, 124 F. (2) 128 .... 11, 15
Hopkins v. *Texas Co.*, 62 F. (2) 691 (10th C. C. A.) . 11, 12, 21
International Great Northern Railway Co. v. *Casey*, 46 S. W. (2) 669 (Tex. C. C. A.) 12, 20
Lackey v. *Ohio Oil Company*, 138 F. (2) 449 (10th C. C. A.) 16
Mussellem v. *Magnolia Petroleum Co.*, 231 Pac. 526 .. 16, 17
O'Neal v. *Union Producing Co.*, 57 F. Supp. 440, affirmed 153 F. (2) 157 ..... 11, 15, 22, 24
Phillips Petroleum Co. v. *Ochsner*, 146 F. (2) 138 16
Phillips Petroleum Co., v. *Record*, 146 F. (2) 485 ..... 11, 13, 14, 17, 22, 24
Rains v. *Kentucky Oil Co.*, 255 S. W. 121 (Ky.) 11, 15
Scott v. *Steinberger*, 113 Kan. 7, 213 Pac. 646 ..... 11, 15
Shamrock Oil and Gas Corp. v. *Coffee*, 140 F. (2) 409 . 16, 18
Texas Warehouse Company v. *Imperial Rice Company*, 164 S. W. 396 (Tex. C. C. A.) 12, 20
United States v. *General Motors Corporation*, 323 U. S. 373, 65 S. Ct. 375 10
Warfield Natural Gas Co. v. *Allen*, 261 Ky. 840, 88 S. W. (2) 989 ..... 11, 15

TABLE OF STATUTES CITED

Judicial Code, Sec. 204, as amended by the Act of February 13, 1925, Chap. 229, Sec. 1 (43 Stat. 938; 28 U. S. C. A. Sec. 347) 2

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1946

No. 347

PHILLIPS PETROLEUM COMPANY,
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vs.

CLAY JOHNSON,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

To the Honorable Chief Justice and the Associate Justices of the Supreme Court of the United States:

Petitioner,[1] Phillips Petroleum Company, defendant in the trial court and appellant in the Circuit Court of Appeals respectfully prays that writ of certiorari issue to review a judgment of the United States Circuit Court of Appeals for the Fifth Circuit in Cause No. 11308 on the docket of that court.

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[1] Petitioner will sometimes be referred to as Phillips or the defendant and respondent as Johnson or the plaintiff.

I

Opinions of the Circuit Court of Appeals

The opinions of the Circuit Court of Appeals have not yet been reported. The opinion of the majority of the Court on original hearing is shown at pages 461 to 471 of the Record. The dissenting opinion is at pages 471 to 474. The opinion on first motion for rehearing is at pages 508 to 510, and the opinion on second motion for rehearing at pages 527 to 529.

II

Jurisdiction

The jurisdiction of the court is invoked under Section 204 of the Judicial Code as amended by the Act of February 13, 1925, Chapter 229, Section 1 (43 Stat. 938; 28 USCA Sec. 347).

The judgment of the Circuit Court of Appeals was entered o nFebruary 1, 1946, (D. 474). Motion for rehearing was filed on the 19th day of February, 1946, (R. 475) and denied March 22, 1946, (R. 508). Second motion for rehearing was filed April 8, 1946, (R. 512) and denied May 17, 1946, (R. 529). This petition for writ of certiorari is filed within ninety (90) days thereafter.

III

Summary Statement of Matters Involved

Respondent, as lessor, sued petitioner, as lessee, to recover additional royalties on gas produced alleged to be due under an oil and gas lease which provided for the payment of royalties on the following basis:

> "If any well on said premises shall produce natural gas in paying quantities and such natural gas is used off the premises or marketed by lessee, the lessor shall

be paid *at the rate of 1/8 of the net proceeds derived from the sale of gas at the mouth of the well.*" (R. 37)[2]

There is no controversy as to the volumes of gas produced nor as to the utilization actually made of the gas by defendant. None of the gas was sold at the well nor at any other point in its natural state. All of it was taken directly into what is known as defendant's Rock Creek Pipeline Gathering System in which it was commingled with gas produced from 200 or 300 other wells. The Rock Creek System is a pipe line system gathering raw gas at the wells in Moore and Hutchinson Counties, Texas, and transporting it to eight gasoline plants owned by Phillips where the mixture of gases was processed for the extraction of natural gasoline (R. 264, 269-70, 272, 298-9). When the Johnson gas was mingled with the mixture its identity was lost (R. 297-9). This commingling of the gases before processing in a gasoline plant is an economic necessity and was acquiesced in by plaintiff (R. 297-9, Second Op. on Reh. 528).

The raw natural gasoline extracted from the mixture in the several gasoline plants was transported by pipeline to a central fractionator owned by Phillips located near the town of Borger, Texas, in Hutchinson County (R. 266). Either in the pipeline or at the treater the gasoline was mingled with other natural gasoline manufactured in other gasoline plants of Phillips in the Panhandle Field, with natural gasoline manufactured by Phillips in gasoline plants located in West Texas and Eastern New Mexico, with natural gasoline purchased from other manufacturers in the Panhandle Field, and with straight run gasoline refined from oil by Phillips in its Borger refinery (R. 265, 268, 275-9, 302).

At the fractionator numerous products were fractionated and manufactured from the commingled gasoline

[2] All emphasis supplied except where otherwise stated.

(R. 266, 268, 280). Some of these products were transported to various markets throughout the country and sold for varying prices (R. 266, 268). Others were delivered to Phillips' Borger Refinery, Rice Plant, aviation blending plant, Kansas City refinery, and Capok Plant in Oklahoma where they were used as intermediate raw materials or blending stocks for making other products. The ultimate manufactured products were transported by truck, tank car, pipeline and barge throughout the Midwest and sold (R. 266, 268, 280-5). It was impossible to trace the Johnson gas into the products so manufactured or into the proceeds thereof, and the court so found (R. 267, 281-5, 464-5, 528).

After the extraction of gasoline from the gas there remained a residue in the form of gas, part of which was transported and sold for the manufacture of carbon black and part of which was sold for light and fuel or used by defendant as fuel in its several plant operations (R. 268). Both parties agreed that because of the mingling of the gases and because the several gasoline plants did not extract a uniform grade of gasoline, even at the same plant, it was impossible to determine how much gasoline was taken from the Johnson gas at any plant nor how much of the Johnson gas was included in any day's sale of residue gas nor the proceeds from the Johnson gas separately from the sale of either the gasoline or the residue gas (Second Op. on Reh. 528).

Plaintiff contended that since the gas was not sold at the well he was entitled to be paid on the basis of the proceeds from the products manufactured from the gas, and since such proceeds could not be determined as to the Johnson gas separately he should be paid on the value of such products as representing the proceeds which could have been received less the cost of transportation, manufacture and sale.

Defendant contended that the royalty provision contemplated a sale of the gas in its raw state as produced at the well and that since it was not sold but was used for the manufacture of gasoline, residue gas and ultimately other products, and since the Johnson gas could not be traced separately into the proceeds of any of such products the royalty provision failed and royalties should, therefore, be determined on the basis of the market value of the gas at the wells.

The trial court construed the royalty provision to require payment of ⅛ of the fair and reasonable value of the raw gas at the gasoline plants less a reasonable charge for transportation (R. 373).

Plaintiff offered evidence to show the value of the gasoline which could have been manufactured from the gas and the value of the carbon black which another carbon black manufacturer in the field manufactured from other similar residue gas. No evidence was offered of the market value of the gas or that it had no market value. The case was submitted to a jury which returned a verdict of $15,986.33, including interest at the rate of 6% per annum, on which judgment was entered.

Holdings of the Majority of the Court

On appeal by defendant the Circuit Court of Appeals for the Fifth Circuit by a divided court reversed and remanded the case. The holdings of the majority are reflected in the Court's Original Opinion (R. 461-471), its Opinion on First Rehearing (R. 508-510), and tis Opinion on Second Rehearing (R. 527-29). In these opinions the Court held:

1. The law resorts to "fair value" or "fair market value" when proceeds are stipulated, and there is no sale. Insofar as the gas was "used" there could be no

"net proceeds derived at the mouth of the well" and "fair value" must be resorted to. Insofar as the gas was "marketed" the stipulation for "net proceeds derived" ought to be enforced giving effect to the words "net at the mouth of the well" by allowing as expenses the cost of transporting, separating and marketing the gas. (Orig. Op. R. 463-465.)

2. The mingling of the Johnson gas with other gas and the extraction of the gasoline vapors from the mixture was not a "use" of it within the meaning of the contract (Orig. Op. R. 464).

3. When the liquid (raw gasoline) was by more intricate processes further altered, separated and blended into other hydrocarbon compounds it might be well-considered a "use" in manufacture so the proceeds derived from the sale of the products could not be followed into the account and only the fair value of the condensed liquid before manufacture be considered, it having been used and not sold (Orig. Op. R. 464).

4. The royalties should be determined by "one-eighth of the *fair value* of the gasoline separated out and used and one-eighth of *the proceeds of sale* of the residue gas, less a proper credit for cost of transportation, separation and sale (Orig. Op. R. 465). (Court's emphasis.)

5. Phillips had the right to mingle the Johnson gas with other gas for convenient and profitable handling. Plaintiff has known that the gas in which he was interested was thus mingled and in the monthly accounting was treated as average gas in the mixture and has acquiesced therein (Second Op. on Reh. R. 528).

6. The gas mixture which included the Johnson gas was taken into several gasoline extraction plants which

did not extract a uniform grade of gasoline even at the same plant and the residue gas was in consequence of varying richness and price. Both parties agree that it is impossible to tell how much gasoline was taken at any plant from the Johnson gas and how much Johnson gas was included in any day's sales of residue. After the commingling it is impossible to follow the Johnson gas separately or to say how much gasoline was taken from it or what its residue sold for separately (Second Op. for Reh. R. 527).

7. When the mixture of average gases was lawfully brought about the Johnson gas no longer existed separately but he acquired a corresponding interest in a portion of the mixture and is entitled to an account of 1/8 of that fractional part of the gasoline made from the mixture. Since the gasoline was not sold, there were no proceeds and its value must be substituted. He is entitled to an account of 1/8 of the fractional part of the net proceeds of residue gas sold from the mixture no matter what its grade or how many its purchasers (Second Op. for Reh. R. 528).

8. Defendant's motions for directed verdict and judgment, notwithstanding the verdict, were based on the fact that market price or value of raw gas at the mouth of the well was not proved. Under the view taken by the court of the proper rule for accounting, such evidence was not necessary or pertinent (Orig. Op. R. 466).

The court also held that plaintiff's proof of the value of the residue gas by evidence of the carbon black manufactured by J. M. Huber Corporation from other residue gas was erroneously admitted in evidence (Orig. Op. R. 465-6). The Court held that the charge to the jury was erroneous in certain particulars; that plaintiff had not

made out a *prima facie* case to bar the running of the statute of limitations and that interest had been erroneously assessed against defendant on a portion of the judgment. For these errors the case was reversed and remanded for a new trial in accordance with the opinion of the Court. (R. 461-471.) These matters are not involved in this petition, which relates solely to the construction given the royalty provision and the application of such construction to the admitted facts in the case.

The Dissenting Opinion

In the dissenting opinion one member of the Court contended the judgment of the trial court should be affirmed stating:

1. "The evidence is without dispute that the defendant *used the gas off the premises,* and what I earnestly contend is that when this gas was removed from the well and commingled with the gas from other gas wells, *at that time* the defendant *used* the gas and immediately owed the plaintiff the fair market value therefor." (R. 471). (Court's emphasis).

2. There was no market price for the gas at the mouth of the well and plaintiff was entitled to receive the fair market value of ⅛ of the net proceeds which means the receipts less expenses of removing the gas to where it was used. The dissenting judge further asserted that plaintiff had sustained the burden of proving the fair market value of the gas and that, therefore, the judgment should be affirmed (R. 471).

IV

Questions Presented

1. Whether the commingling of the Johnson gas with gas produced from other wells so its identity was lost in the mixture and the processing of the mixture in eight gasoline

plants and the sale of a part of the products manufactured and the use of others in the manufacture of still other products so that it was impossible to trace the Johnson gas into the proceeds of any of the products manufactured from the mixture constituted a fact situation whereby the provision to pay "the net proceeds derived from the sale of gas at the mouth of the well" could be literally applied to determine royalties or whether such royalty provision failed so that royalties should be determined by the market value of the gas at the well.

2. Whether the commingling of the Johnson gas with gas produced from several hundred other wells and the processing of the mixture for its gasoline content in eight gasoline plants was a "use" of the gas within the meaning of the royalty provision.

3. Whether the holding that royalties should be determined by "⅛ of the fair value of the gasoline separated and used and ⅛ of the proceeds of the sale of residue gas, less a proper credit for the cost of transportation, separation, and sale," where it was admitted that the proceeds of the Johnson gas could not be traced into the products manufactured from the mixture of gases, is in fact an evaluation determination of royalties without prior proof of the market value of the gas or that there was no such market value.

4. Whether under a royalty provision for payment of "⅛ of the net proceeds derived from the sale of gas at the mouth of the well" the proceeds contemplated by the parties were those of a sale of the gas in its raw state as produced at the well rather than the proceeds of products manufactured from the gas at distant points after it had been mixed with other gases.

V

The Writ Should Be Granted Although the Case Was Reversed and Remanded by the Court of Appeals

While the Court of Appeals reversed the District Court, the case was remanded with instructions for a retrial in accordance with the opinion of the Court of Appeals (R. 474). The primary issue before the Court of Appeals was the construction to be given the royalty provision of the lease and the application thereof to the facts of the case. The reversal was on other grounds. If the construction given the lease by the Court of Appeals is erroneous and that contended for by petitioner is correct and grounds otherwise exist for granting the writ, the fact that the case was remanded for new trial and petitioner in that degree won the appeal is no bar to the propriety of granting the writ applied for. If petitioner's construction of the lease is ultimately determined to be correct, a retrial of the case in accordance with the opinion of the Court of Appeals would be a waste of time and money. This Court has in the past granted writs of certiorari to obviate such waste, holding that the ruling of the Court of Appeals was "fundamental to the further conduct of the case." *United States* v. *General Motors Corporation*, 323 U. S. 373, 65 S. Ct. 375.

VI

Reasons Relied On for Allowance of the Writ

1. *The holding of the Court of Appeals that, under a royalty provision which reads "the lessor shall be paid at the rate of 1/8 of the net proceeds derived from the sale of gas at the mouth of the well," where the gas was not sold at the well but commingled with other gas produced from hundreds of other wells so its identity was lost in the mixture, and the mixture processed in eight gasoline*

plants and a part of the products manufactured used in making other products and part of them sold so that it was impossible to trace the Johnson gas into the proceeds of any of the products manufactured from the mixture of gases, that royalties should not be determined by the market value of the gas at the well but by 1/8 of the fair value of the gasoline separated out and used and 1/8 of the proceeds of sale of the residue gas, less a proper credit for the cost of transportation, separation, and sale" is a decision of an important question of law probably in conflict with the decisions of other Circuit Courts of Appeals and with prior decisions of the same Court of Appeals.

Hopkins v. *Texas Co.*, 62 F(2) 691 (10th CCA);
Phillips Petroleum Company v. *Record*, 146 F(2) 485;
Armstrong v. *Skelly Oil Company*, 55 F(2) 1066;
Dunn v. *Republic Natural Gas Co.*, 124 F(2) 128;
O'Neal v. *Union Producing Co.*, 57 F. Sup. 440; aff. 153 F(2) 157;
Warfield Natural Gas Co. v. *Allen*, 261 Ky. 840, 88 SW(2) 989;
Scott v. *Steinberger*, 113 Kan. 7, 213 PAC. 646;
Rains v. *Kentucky Oil Company*, 255 SW 121 (Ky.).

Both the majority and minority opinions recognized that where a contract provides for payment of proceeds and there were no proceeds of the character stipulated by the parties, the law resorts to market value as the measure of compensation (Orig. Op. 463-464), (Dissenting Op. 471). The dissenting judge found that the gas was so used as to call for the operation of this rule. (Dissenting Op. 471). His error lay in assuming that there was no fair market value for the gas and that proof of actual value of the character offered by plaintiff was admissible although plaintiff admits in his brief filed in the court below (pp. 163, 119) that if his royalties are to be determined by the market value of the gas he did not make out a case.

The conclusion of the dissenting judge in this regard is clearly contra to the governing decisions of the Texas Courts.

International Great Northern Railway Co. v. *Casey*, 46 SW(2) 669 (Tex. CCA);
Continental Oil & Cotton Company v. *Wristen & Johnson*, 168 SW(2) 395 (Tex. CCA);
Texas Warehouse Company v. *Imperial Rice Company*, 164 SW 396 (Tex. CCA).

The undisputed facts concerning the utilization made of the gas reflect that the proceeds of the Johnson gas at the mouth of the well could not be determined either as to the gasoline or the residue gas. It is the position of petitioner that the facts found by the Court of Appeals called for the application of the market value rule because there were not ascertainable proceeds of the character stipulated in the lease and that the refusal of the court to apply such rule is in conflict with the decision of the Tenth Circuit Court of Appeals in the case of *Hopkins* v. *Texas Company*, 62 F(2) 691, with several prior decisions of the same Court of Appeals and with decisions of other courts.

The majority of the Court having found that because of the commingling of the gases and the processing of the mixture in several gasoline extraction plants so that it was impossible to follow the Johnson gas separately to determine how much gasoline was taken from it or what its residue sold for, should have followed the decisions in all other cases including its own in holding that there were no proceeds of the character contemplated by the parties and that the compensation was to be determined by the market value of the gas at the well.

In *Hopkins* v. *Texas Company*, 62 F(2) 691 (10th C. C. A.), the royalty provisions of three leases were involved. The first provided for payment of a royalty of ⅛ at the prevail-

ing market price, the second, "to pay lessor for gas produced from any oil well and used off the premises *at the rate of ⅛ of all gas sold as gas is sold,*" the third, for payment of "⅛ of the market value of the gas." The Texas Company, as lessee, took the gas from all three leases into its gasoline plant where it manufactured gasoline and residue gas. The specific language of the three royalty provisions is taken from the unpublished opinion of the District Court. It is significant that the Circuit Court held *"the leases are not essentially different.* • • • The third subdivisions obligate the lessee to account for ⅛ of the gas from an oil well when used off the premises or in the manufacture of gasoline or any other product and when used for the manufacture of gasoline."

Plaintiff contended he was entitled to be paid royalties on the basis of the *gasoline* and *residue gas* manufactured from the gas. This is plaintiff's contention here which was upheld by the Court of Appeals. It is to be noted that the provision in the second lease for payment of royalties "at the rate of ⅛ of all gas as gas is sold" calls for payment of proceeds, the same as the Johnson lease. The Tenth Circuit Court of Appeals, nevertheless, held that plaintiff was not entitled to be paid *on the basis of the products manufactured from the gas,* that the royalty provisions of the second lease were not essentially different from those of the leases expressly providing for payment on the basis of market value and that the computation of royalties in accordance with the usual and customary method in the area—i.e. market value—discharged the royalty obligation of the lessee. The Court of Appeals here refused to follow the *Hopkins* case although the facts demonstrated even more clearly than in the *Hopkins* case that there were no proceeds from the sale of the gas at the well.

The court's opinion is likewise in conflict with its own prior decision in the case of *Phillips Petroleum Company* v.

Record, 146 F(2) 485. The royalty provision in that case provided:

> "To pay lessor ⅛ of the gross proceeds each year payable quarterly for the gas from each well where gas only is found while the same is being used off the premises, and if used in the manufacture of gasoline, a royalty of ⅛ monthly at the prevailing market rate for gas."

Part of the gas was taken into the same pipe line gathering system which gathered the Johnson gas and was processed in the same gasoline plants. The case was a companion case to *Phillips Petroleum Company* v. *Ochsner,* 146 F(2) 138, in which the royalty provision was specifically for ⅛ of the value of the gas at the mouth of the well. The Court held that *this difference was immaterial* and that "the argument to which appellees devote a good portion of their brief, that the provision for payment to them of one-eighth of the gross proceeds of the gas from their well entitled them to receive not one-eighth of the market value of the gas received in exchange but one-eighth of the market value of the products manufactured from that gas, will not at all do," and rejected the contention. Plaintiff's theory of recovery here is the same as that of plaintiffs in the *Record* case with the exception that he proposes to allow deduction of costs because of the inclusion of the world "net" in the royalty provision.

The construction given the lease by the Court of Appeals is likewise in conflict with its prior decision in *Armstrong* v. *Skelly Oil Company,* 55 F(2) 1066. In that case one of the applicable royalty provisions was "to pay lessor a royalty of ⅛ the price received by lessee payable monthly for gas from each well where gas only is found while the same is being used off the premises * * *." Skelly, the lessee, commingled the gas produced with other gas, processed the

mixture through a gasoline plant and sold the residue gas for the manufacture of carbon black, *the precise disposition made of the Johnson gas.*

Plaintiff contended that he was entitled to be paid royalties on the basis of the sales price of the gasoline extracted and the proceeds received from the residue sold for the manufacture of carbon black, *the very contentions of plaintiff here and the construction given the lease by the Court of Appeals.* The Court of Appeals in its opinion in the *Skelly* case written by Judge Hutcheson rejected that contention and held that payment on the basis of the market value of the gas discharged the obligation of the lessee.

The opinion of the Court of Appeals is also in conflict with its prior holdings in *Dunn* v. *Republic Natural Gas Company,* 124 F(2) 128 and *O'Neal* v. *Union Producing Company,* 57 F. Sup. 440, affirmed 153 F(2) 157. It is likewise in conflict with the tenor of decisions generally.

In *Warfield Natural Gas Company* v. *Allen,* 261 Ky. 840, 88 SW(2) 989, the provision was for payment of "one-eighth of proceeds received from the sale" of the gas. The lessee transported the gas to distant points where it was sold for a price in excess of the market price of gas at the wells in the field. The court held that the parties contemplated that the royalties should be determined at the well and that payment of the customary wellhead price discharged the lessee's obligation even though "it may market the gas elsewhere and get a much greater sum for it."

In *Scott* v. *Steinberger,* 113 Kan. 7, 213 Pac. 646, and *Rains* v. *Kentucky Oil Company,* 255 SW 121 (Ky.), royalty provisions for payment of ⅛ of the gas were construed to require payment of no more than the market price of the gas at the connection to the pipe line although the gas was marketed elsewhere for a greater sum.

The majority of the court in their original opinion stated: "We have not discussed the meaning and effect given

royalty provisions in the many cases cited to us (which included the cases cited above) because in none of them were the words and facts like this case." While it is true that none of the royalty provisions in the cases cited contain word for word the identical language of the Johnson provision, it is submitted that provisions for payment of "proceeds" for "gas sold as gas is sold" and of "the price received by lessee" are provisions for payment of proceeds which cannot be distinguished from the Johnson royalty provision. In fact, the Johnson royalty provision even more precisely defines the proceeds stipulated as proceeds from a sale of the gas in its natural state at the well. It is likewise submitted that the facts concerning the utilization of the Johnson gas cannot be distinguished from the utilization made of the gas involved in the cases cited. There being no valid basis of distinction, the opinion of the Court of Appeals construing the Johnson lease is in conflict with the cases cited, and this Court should take jurisdiction to resolve that conflict.

2. *The holding of the Court of Appeals that the commingling of the Johnson gas with gas produced from hundreds of other wells and the processing of the mixture for its gasoline content in eight gasoline plants was not a "use" of the gas is a decision of an important question of law probably in conflict with the decisions of other Circuit Courts of Appeals and with prior decisions of the same Court of Appeals.*

Lackey v. *Ohio Oil Company,* 138 F(2) 449 (10th C. C. A.);
Mussellem v. *Magnolia Petroleum Co.,* 231 Pac. 526;
Shamrock Oil and Gas Corp. v. *Coffee,* 140 F(2) 409;
Phillips Petroleum Co. v. *Record,* 146 F(2) 485.

The dissenting judge held that the commingling of the Johnson gas with gas produced from other wells and the

processing of the mixture in defendant's plants was a use of the gas off he premises. (Dis. Op. 471.) The majority held that such commingling and manufacture of gasoline did not constitute a "use" of the gas (Orig. Op. 464). It is submitted that the dissenting opinion on this point is correct and that the opinion of the majority of the Court is in conflict not only with opinions of other Circuit Courts and State decisions but with its own prior opinions.

In *Lackey* v. *Ohio Oil Company*, 138 F(2) 449, the Tenth Circuit Court of Appeals construed a royalty provision for payment of $200.00 each year in advance for gas from each well where gas only is found "while the same is being used off the premises." The lessee sold part of the gas to another for the manufacture of natural gasoline therefrom and the lessor sued for conversion of the gas so sold contending that it was not "used off the premises." The Circuit Court overruled this contention holding that:

> "In accordance with the doctrine announced in Erie R. Co. v. Tompkins, 304 U. S. 64, 58 S. Ct. 817, 82 L. Ed. 1188, 114 A.L.R. 1487, we are compelled to hold that the phrase 'used off the premises' in the third paragraph of the royalty provisions of the lease here involved means gas 'appropriated to a purpose foreign to utilization' for the development of the lease. Moreover, the gas was used off the premises and the phrase 'off the premises' is not limited to use by the lessee. We regard it immaterial whether such use was by the lessee or by a person to whom the lessee sold the gas."

The case arose in Oklahoma, and the Court referred to and relied on *Mussellem* v. *Magnolia Petroleum Company*, 107 Okla. 183, 231 Pac. 526, which likewise held that the processing of natural gas for the manufacture of gasoline in the gasoline plant was a "use" of the gas. The holding of the majority of the Court is also clearly in conflict with its prior holdings in the cases of *Phillips Petroleum Com-*

pany v. *Record*, 146 F(2) 485 and *Shamrock Oil and Gas Corporation* v. *Coffee*, 140 F(2) 409.

In the *Record* case one part of the royalty provision provided "if used in the manufacture of gasoline a royalty of ⅛ payable monthly at the prevailing market rate for gas." During a portion of the period involved in the suit the gas produced from the Record well was commingled in the same gathering system and processed in the same plants in which the Johnson gas was processed. As to such gas the Court held:

> "As to the gas run directly into the defendant's plant for the manufacture of gasoline, the lease *specifically provides that it shall be paid for at the prevailing market rate for gas.*"

In so holding the Court necessarily found and held that the gas processed in defendant's gasoline plants was "*used in the manufacture of gasoline.*" *It is to be noted that the Court did not hold that only the percentage of the gas liquified in the extraction process was "used in the manufacture of gasoline" but that all of the gas was so used and that defendant's obligation was to pay the prevailing market rate for gas not the value of the gasoline and the proceeds of the commingled residue.*

In the *Shamrock* case the royalty provision read:

> "On gas produced from said land and sold or *used off the land*, or *in the manufacture of gasoline*, including casinghead gas, the market price at the well of ⅛ of the gas so sold or used, provided that if and when lessee shall sell gas at the wells, lessor's royalty thereon shall be ⅛ of the amount realized from such sale."

Shamrock took the gas into its gathering system, commingled it with other gas, processed the mixture for the manufacture of gasoline in its plant, and sold the residue for the manufacture of carbon black, the same utilization

as that made of the Johnson gas, and the Court held the gas was used for the manufacture of gasoline. Both the facts and the conclusion are clearly reflected in the Court's opinion.

> "Under the contract the Defendant took the gas from wells which it had drilled on the Plaintiff's land and transported same through the pipes of its gathering system to its plant. In the process of gathering and transporting gas from well to plant it becomes commingled with large volumes of similar gas from other wells. *At the plant of the Defendant the gas was used for manufacturing gasoline, butane, and propane.. The residue was sold by the lessee principally to carbon black plants for utilization in the manufacture of carbon black.* • • • The contract is that if Shamrock sold the gas at the mouth of the well the royalty owners would take their part of what it sold for. In the event the gas were *used* by Shamrock to make gasoline or otherwise, or was sold after being removed from the lease, the royalty owners were to have the 'market price' at the mouth of the well. A little was sold to drillers and the like away from the lease, but it is negligible, and would fall under the market price provision. *The great bulk of the gas was used to extract gasoline and butane, with the residue sold for carbon black.* The 'market price' at the well is, therefore, the only applicable contract provision."

The fact that the mixed residue, after the gasoline was extracted, was sold for the manufacture of carbon black was immaterial to the conclusion that all of the gas was used for the manufacture of gasoline although only a part was liquified in that process. The same may be said of virtually any raw material used in the manufacture of a finished product.

3. *The holding of the Court of Appeals that "the measure of accountability is one-eighth of the fair value of the gasoline separated out and used, and one-eighth of the proceeds of sale of the residue gas, less a proper credit for the cost of transportation, separation and sale" where it was admitted that the proceeds of the Johnson gas could not be traced into the products manufactured from the mixture is in effect a holding that royalties should be determined by the actual value of the gas without prior proof of no market value, which holding is a decision of an important question of local law probably in conflict with applicable local decisions.*

International Great Northern Railway Co. vs. *Casey*, 46 S. W. (2) 669 (Tex. C. C. A.);

Continental Oil and Cotton Company vs. *Wristen & Johnson*, 168 S. W. 395 (Tex. C. C. A.);

Texas Warehouse Company vs. *Imperial Rice Co.*, 64 S. W. 396 (Tex. C. C. A.).

The majority of the Court found that the gasoline manufactured from the gas was so used that it could not be traced into the account so that the value of such gasoline must be resorted to in arriving at the royalties (Orig. Op. 464). As to the residue, however, the Court found that the residue of the mixture was sold and held that plaintiffs were entitled to be paid an allocate part of the proceeds from such mixture (Orig. Op 464-466). This holding was made in the face of the agreement by both parties and of the finding of the Court that after the commingling of the gas and because the several gasoline plants did not extract a uniform grade of gasoline even at the same plant it was impossible to follow the Johnson gas separately to determine how much gasoline was taken from it or what its residue sold for separately (Second Op. on Reh. 527).

It is, therefore, apparent from the face of the opinion that the proceeds from the mixture which the court held should be allocated to the Johnson gas were not the proceeds in fact received from any part of the Johnson gas separately because it was impossible to determine such proceeds. Although the Court elected to denominate the compensation as "proceeds" it is in fact an evaluation determination and does not purport to be the proceeds in fact received from the sale of the Johnson gas either in its natural state at the well or from the products made therefrom. The compensation allowed by the Court being in fact based on value, the Court's holding that proof of market value was immaterial and that the compensation could be shown by other proof than that of market value was clearly in conflict with the decisions of the State Courts of Texas. The State decisions unanimously hold that where a party's compensation is to be determined by the value of a commodity its market value is determinative and the absence of such a market value must first be shown before proof of actual value is admissible.

4. *The holding of the Court of Appeals that under a royalty provision for a payment of "1/8 of the net proceeds derived from the sale of gas at the mouth of the well" the proceeds contemplated by the parties were not those from a sale of the gas in its natural state as produced at the well but from products manufactured from the gas is a decision of an important question of local law probably in conflict with applicable local decisions, with decisions of other Circuit Courts of Appeals and with prior decisions of the same Court.*

Danciger Oil & Refineries, Inc. vs. *Hamill Drilling Co.*, 171 S. W. (2) 321 (S. Ct. of Tex.);

Hopkins vs. *Texas Company*, 62 F(2) 691 (10th C. C. A.);

Phillips Petroleum Company vs. *Record,* 146 F(2) 485;

O'Neal vs. *Union Producing Co.,* 57 F. Sup. 440; Aff. Aff. 153 F(2) 157.

It is to be noted that the royalty provision is for payment of proceeds derived from the "sale of *gas* at the mouth of the well." It is the position of petitioner that the gas contemplated by the parties from sale of which the proceeds were to be derived was the gas as produced at the well in its raw state and not the proceeds of products eventually manufactured therefrom in manufacturing plants at distant points.

In *Danciger Oil and Refineries, Inc.,* vs. *Hamill Drilling Company,* 171 S. W. (2) 321, the Supreme Court of Texas held that an overriding royalty provision for payment out of gas meant *gas* as produced from the well in its *raw* form and not the products ultimately manufactured from the gas by the producer. The overriding royalty involved in that case was for payment of 1/24 of all of the oil, gas and casinghead gas produced from the leased premises at the prevailing market price paid by major companies in the Gulf Coast Area. Danciger, the producer, did not sell the gas but used it in a gasoline plant in which it manufactured gasoline, gas-oil, distillate, kerosene, butane, propane and residue gas. Plaintiff contended that since there was no market price for gas at the wells in the Gulf Coast Area it was entitled to be paid 1/24 of the receipts from the products manufactured from the gas. Danciger contended it was liable only for 1/24 of the value of the crude gas as produced at the wells. The Supreme Court held:

> "It (the contract) further provides that the payment shall be 'payable out of the products named, and does not constitute a personal obligation.' *No provision*

was made for the processing of the products, nor for the payments to be made out of the processed products. On the contrary, *the payments were to be made out of the products named.* Among the products named is *'gas.'* The parties knew what kind of gas was being produced from the properties when the contract was entered into. *Consequently, payments out of the gas as was then being produced, and as was clearly understood by the parties, constitute full compliance with the contract.* • • •

" • • • In our opinion, Hamill, having stipulated for payment out of *'gas,'* with full knowledge of the kind of gas that was being produced from the premises, is bound to accept *payments out of the gas as it was then being produced from the wells, and is not entitled to have the gas refined into some other commodity. Armstrong* v. *Skelly Oil Co.*, 5 Cir., 55 F. 2d 1066; *Magnolia Pet. Co.* v. *Connellee,* (Tex. Com. App.) 11 S. W. 2d 158."

Unquestionably, if the Supreme Court in the *Danciger* case had had before it a royalty provision for payment of ⅛ of the proceeds from gas at the well it would have held, to paraphrase the court's opinion, *that no provision was made for the processing of the products nor for payment to be made out of the processed products,* and that on the contrary the *payments were to be made out of the gas, the products* named, and the *only product named in the Johnson royalty provision.* The royalty provision not only specified payment from gas but *at the mouth of the well.* At that point, the gas was in its crude or natural state and gasoline and residue resulted *only after it was mingled with other gases, transported to distant points and subjected to extraction processes.*

The Tenth Circuit Court of Appeals necessarily reached the same conclusion in *Hopkins* v. *Texas Company,* 62 F(2) 691, without articulating on the point when it held that

under a royalty provision for payment "at the rate of 1/8 of all gas sold as gas is sold" the royalty owner was not entitled to be paid on the basis of the *gasoline* and *residue* manufactured from the gas but on the market value of the gas separated into its constituent elements as determined by the usual and customary method of purchasing gas and accounting for royalties in the area.

The decision is likewise contrary to the prior holding of the same Court of Appeals in *Phillips Petroleum Company* v. *Record,* 146 F(2) 485 wherein the court rejected the contention of the royalty owners that they were entitled to be paid on the basis of 1/8 of the market value of the *products manufactured* from the gas and held that their compensation was limited to 1/8 of *the market value of the gas as produced at the well.*

In the very recent case of *O'Neal* v. *Union Producing Company,* 57 F. Sup. 440, 153 F(2) 157, the same Court of Appeals held that a royalty provision requiring the lessee to pay "1/8 of the net proceeds at prevailing market price at well for gas" did not entitle the plaintiff to the gasoline taken from the gas but only to the market price of the gas at the well. Holding the gasoline was merely a constituent part of the natural gas the court said:

> "The royalties provided for in the contract were for the *gas* and *not* for the *gasoline* and *also for any elements that might later be taken by some artificial process from that gas.*"

VII

Conclusion

It is, therefore, submitted that this case is one calling for the exercise by this Court of its supervisory powers in order to resolve the conflicts between the opinion of the Court of Appeals and the decisions of other Courts of Appeals and

of the State Courts of Texas and that a writ of certiorari should be granted and this Court review the decision of the United States Circuit Court of Appeals for the Fifth Circuit and finally reverse it.

Respectfully submitted,

DON EMERY,
RAYBURN L. FOSTER,
E. H. FOSTER,
CHARLES B. COCHRAN,
WARREN M. SPARKS,
Counsel for Petitioner,
WARREN M. SPARKS,
Of Counsel.

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